

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
CORPORATE GOVERNANCE FUND INVESTMENT VEHICLES –
EXTERNALLY MANAGED**

October 17, 2005

This Policy is effective immediately upon adoption and supersedes all previous Corporate Governance Fund Investment Vehicles – Externally Managed policies.

I. PURPOSE

This document sets forth the investment policy (“the Policy”) for Global Equity, with respect to Corporate Governance Fund Investment Vehicles (“Corporate Governance Funds”). In addition, this Policy applies to those Investment Vehicles enumerated in Section V.B. The design of this Policy ensures that investors, [managers](#), consultants, or other participants selected by the California Public Employees' Retirement System (“the System”) take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the global capital markets.

II. STRATEGIC OBJECTIVE

Broadening the opportunity set of the System’s investment portfolio for achieving investment returns not available in traditional public markets investments is the strategic objective of investments in Corporate Governance Funds.

Corporate Governance Funds are offered in a [limited partnership](#) or [limited liability company](#) (LLC) form, when the majority of the underlying investments are publicly traded. Corporate Governance Funds include, but are not limited to, strategic block investment funds or crossover funds where the underlying investments consist of both public and private investments.

Corporate Governance Funds shall be selected to accomplish the following:

- A. Diversify the System’s overall Equity Program by complementing the Passive Domestic Equity Program;

- B. Enhance the expected return of the System's investment program.
- C. Hedge against active member (pre-retirement) liabilities; and
- D. Consider solely the interest of the System's participants and their beneficiaries in accordance with California State Law.

III. RESPONSIBILITIES AND DELEGATIONS

- A. The **System's Investment Committee** ("the Investment Committee") is responsible for approving and amending this Policy. The Investment Committee delegates the responsibility for administering Corporate Governance Funds to the System's Investment Staff.
- B. The **System's Investment Staff's** ("the Staff") duties include, but are not limited to, the following responsibilities:
 - 1. Developing and recommending this Policy to the Investment Committee.
 - 2. Developing and maintaining a procedures manual, subject to periodic reviews and updates, outlining Staff operational procedures used in implementing this Policy.
 - 3. Implementing and adhering to this Policy.
 - 4. Evaluating, selecting, and allocating up to \$200 million in Corporate Governance Funds, including the possibility of obtaining equity stakes in management firms under this strategy.
 - 5. Monitoring selected Investment Partner(s) to determine if the partners' actions and investment results are consistent with the System's manager monitoring policies. Monitoring may be accomplished through the General Pension Consultant or Staff.
 - 6. Reporting to the Investment Committee concerns, problems, material changes, and all violations of Guidelines and Policies immediately and in writing, along with explanations and appropriate recommendations for corrective action.
 - 7. For accounting purposes, investments made in private equity securities shall be valued based upon generally accepted

methods for such securities including those methods used by the AIM program.

- C. The **General Partner(s)** is responsible for all aspects of portfolio management as set forth in the investment partner's contract with the System and shall fulfill the following duties:
 - 1. Communicate with Staff as needed regarding investment strategy and investment results. The investment partner(s) is expected to monitor, analyze, and evaluate performance relative to the agreed-upon benchmark.
 - 2. Cooperate fully with the System's Staff, **Custodian**, and General Pension Consultant on requests for information.
 - 3. Comply completely with the System's mandated reporting requirements, including but not limited to, accounting for fees, expenses, capital investments, and dispositions.
- D. The **General Pension Consultant** shall monitor and evaluate performance relative to individual benchmarks and this Policy, in accordance with its contract with the System.
- E. Due diligence on, evaluation of, and independent recommendations on perspective Corporate Governance Funds shall be conducted by either the General Pension Consultant or one of the consultants in the Alternative Investment Management Program. The consultant shall be selected by the Senior Investment Officer, in conjunction with the Chief Investment Officer.

IV. PERFORMANCE OBJECTIVE

Corporate Governance Funds are highly specialized investments; therefore, the System shall establish performance objectives for each individual Corporate Governance Fund. These objectives shall be set at levels that are consistent with the strategy employed by the fund manager.

V. INVESTMENT APPROACHES AND PARAMETERS

A. Approach

- 1. Corporate Governance Funds shall be alternatives to other traditional active management vehicles in the Public Markets. Funds for investment in Corporate Governance Funds may come from the active or passive management allocation in each asset category. Corporate Governance

Funds shall not exceed twenty-five percent of the total active management allocation on a market value basis in each asset category.

2. The Program shall use Corporate Governance Funds opportunistically to gain the attractive risk-to-reward characteristics of specialized and unique investment strategies. Corporate Governance Funds are not intended to be a substitute for investment strategies generally available in standard agency agreement format.
3. The Program shall implement Corporate Governance Funds through partnerships, funds, or other formation structures, e.g., limited liability companies (LLCs), where the general partner(s) or fund manager(s) have expertise in the specified mandates and in related areas material to the success of each investment strategy. The justifications for a limited partnership or LLC structure include, but are not limited to, the following:
 - a. Financial Firewall: The limited liability of a partnership or LLC arrangement is important since Corporate Governance Funds sometime use derivatives and leverage. The System, as a limited partner, has the benefit of this limited liability.
 - b. Access Unique Approaches with Limited Liquidity: The key to successful Corporate Governance Fund investing is in selecting vehicles where the specialization of the investment is sufficiently unique that the partnership or LLC structure is justified in limiting asset growth in the strategy, ensuring a proper investment time horizon, and protecting the System from the vagaries of other investors who may not be like-minded. The fees and expenses of investing in Corporate Governance Funds may be higher than traditional active management. The System shall not fund Corporate Governance Funds that simply invest in traditional active management approaches at higher fees.
 - c. Access Unique Talent: The specialized and focused nature of Corporate Governance Funds often requires more specialized investment skills than those needed for traditional active management. Some of these investment professionals manage money only in the

partnership format or LLC structure.

4. The negotiation of terms in Corporate Governance Funds shall protect the interests of the System, and shall address at a minimum the following issues:
 - a. Alignment of Interests: Vehicle terms including fees shall be negotiated to ensure the alignment of the General Partner's interest with the System. The management fee, carried interest, performance objective, return of capital, lock-up period, [clawbacks](#), and other relevant terms shall protect the System in the event of adverse performance results, while ensuring that the limited liability status is maintained. Where appropriate, a return of capital commitments shall be negotiated.
 - b. Leverage: It is recognized that Corporate Governance Funds may expose the System's assets to leverage, meaning that a partnership's market exposure may exceed the market value-adjusted capital commitment by the amount of borrowed capital. Negotiation of corporate governance investment vehicle terms shall consider The System's stated corporate governance level of leverage necessary for achieving the investment's stated objectives without exposing the System to undue risk. The partnership or LLC agreements shall detail the amount of leverage and monitor leverage on a case-by-case basis and in the aggregate, to ensure that expected and realized returns are sufficient and achievable to compensate for the risk incurred. For the Corporate Governance Funds, the limit on leverage shall not exceed 100% of the existing capital without prior Investment Committee approval.
 - c. Reporting Requirements: To appropriately account for fees, individual expenses, invested capital, and any other items affecting the investment, Staff shall prescribe a standard reporting format, which all the General Partners shall follow.
5. The Staff and General Pension Consultant shall continually review the efficacy of Corporate Governance Fund investment vehicles. The Staff shall present a formal review of the approach to the Investment Committee at least every

three years.

B. Investment Selection

1. Corporate Governance Funds may be selected if they enhance the investment program in order to achieve the overall asset class investment goal. Corporate Governance Funds may include investments in domestic and international equity and fixed income asset classes in strategies that may include, but are not limited to, the following areas but must be subject to asset class restrictions:
 - a. Relative Value Funds
 - b. Market Neutral Funds
 - c. Arbitrage Funds
 - d. Derivative-Based Strategy Funds
 - e. [Concentrated or Strategic Block Funds](#)
 - f. Crossover Funds (where public securities and private investments are included in the partnership)
2. The Staff shall develop and maintain selection guidelines for Corporate Governance Funds to include the following:
 - a. Minimum requirements with respect to the following:
 - (1) General Partner Investment Experience
 - (2) Basic Investment Vehicle Terms
 - (3) Investment Goals and Objectives
 - (4) Degree of Leverage
 - b. Performance Criteria
 - c. Due Diligence Process
 - d. Legal Constraints or Requirements
 - e. Reporting Requirements

- f. Quality control processes including, but not limited to, investment monitoring and risk control
 - g. Other relevant parameters that may apply
- 3. Staff shall review opportunities to obtain an equity stake in Corporate Governance Fund managers and make recommendations to the Investment Committee as appropriate. A separate portfolio will be established to provide for performance measurement of CalPERS' equity stakes in Corporate Governance Fund managers.

C. Investment Parameters

Investment partner(s) in Corporate Governance Funds shall operate under a limited [partnership agreement](#), or other similar legal structure, which includes specific, written investment guidelines. The guidelines shall outline the investment partner(s)' investment philosophy and approaches, representative portfolios characteristics, permissible and restricted securities and procedures, and a performance objective commensurate with the investment risk to be incurred.

Implementation of this Program shall comply at all times with the applicable System investment policies.

VI. BENCHMARKS

Due to the wide range of markets in which these investments shall be made, appropriate benchmarks shall be established for each specific Corporate Governance Fund. They shall reflect the investment opportunity set or risk profile of each investment. These benchmarks shall be established prior to investment and shall be documented with each fund manager.

VII. GENERAL

Investors, managers, consultants, or other participants selected by the System shall make all calculations and computations on a fair-market-value basis as recorded by the System's Custodian. In the case of private investments, calculations and computations shall be made consistent with the partnership agreement, unless otherwise approved by the Investment Committee.

VIII. GLOSSARY OF TERMS

Definitions for key words used in this policy are located in the Miscellaneous Glossary of Terms which is included in the System's Master Glossary of Terms.

Approved by the Policy Subcommittee: June 10, 2005

Adopted by the Investment Committee: August 15, 2005

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Adopted by the Investment Committee: October 17, 2005